How STS Has Shaken Up European Securitization So Far

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Key Takeaways

- September 2019 was the first month in which the majority of new investor-placed European securitization issuance carried the simple, transparent, and standardized (STS) label, exceeding €5 billion.
- Introduction of the STS label may have had a mildly positive effect on portfolio credit profiles, with corresponding changes in transactions' capital structures.
- However, issuance without the STS label continues apace, suggesting that it has not introduced any undue stigma and that the two segments should successfully coexist in the future.

Since Jan. 1, 2019, the EU's Securitisation Regulation has given European originators the option of labeling their transactions as "simple, transparent, and standardized" if they meet certain requirements. Introduction of the STS framework has shaken up incentives for both originators and investors. Ten months on, the STS label has gained traction, but how significantly has it changed the European securitization market?

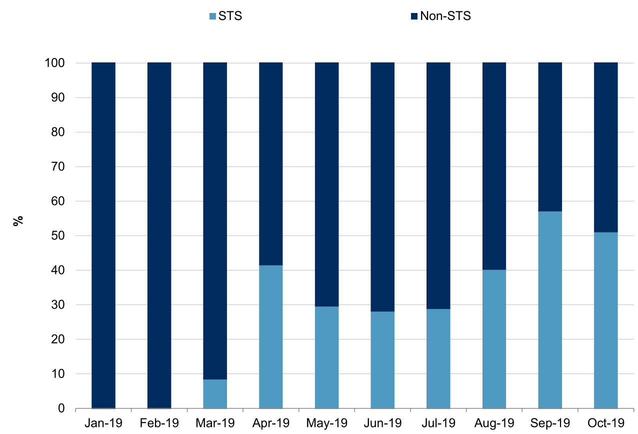
After A Slow Start, STS Issuance Has Taken Off

In the months immediately following their introduction, the STS framework and surrounding regulation proved counterproductive for primary issuance. Although the new rules were already in effect, several associated technical standards remained incomplete, fueling continued uncertainty over some practical details of the STS eligibility criteria and wider disclosure requirements. As a result, many originators initially stayed on the sidelines, leaving investor-placed issuance volumes down by more than 35% year over year at the end of the first quarter.

From late March, however, originators began to take the plunge and issue STS transactions. Confidence in the new regime improved as third-party verifiers received regulatory approval and began to opine on transactions' STS compliance. From the beginning of the second quarter, STS transactions typically accounted for 30%-40% of monthly investor-placed issuance. September was the first month in which more than half of issuance was labeled STS (see chart 1a). At the end of October, more than 40 public, STS-compliant term securitizations had been issued, according to the European Securities and Markets Authority, accounting for nearly 35% of year-to-date volumes (see chart 1b). What's more, originators have also begun to apply the label retrospectively to some transactions issued before 2019, further increasing the pool of outstanding STS issuance.

Chart 1a

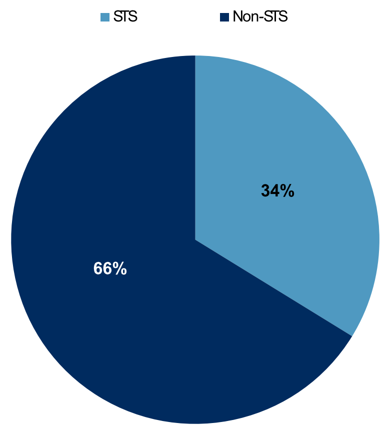
Mix Of Investor-Placed European Securitization Issuance
By Month



STS--Simple, transparent, and standardized. Source: S&P Global Ratings.

Chart 1b

Mix Of Investor-Placed European Securitization Issuance
2019 to date, as of end-October

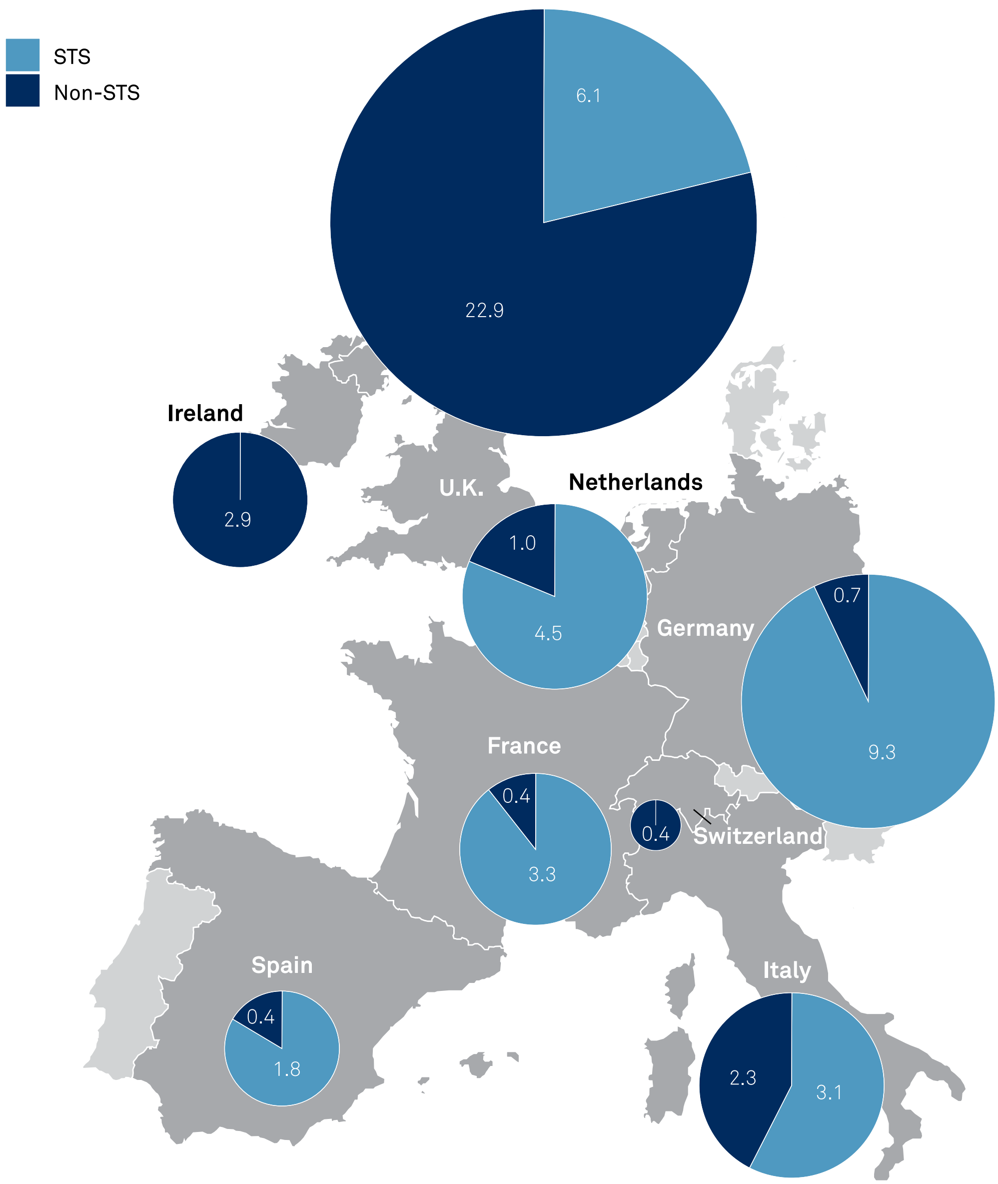


STS--Simple, transparent, and standardized. Source: S&P Global Ratings

Originators' take-up of the new label has been highest in Germany, where more than 90% of investor-placed issuance so far this year has been STS-compliant (see chart 2). By contrast, only 21% of investor-placed issuance backed by U.K. collateral has been labeled STS. This is because nonconforming and buy-to-let residential mortgage-backed securities (RMBS) have made up a large portion of U.K. issuance. Neither of these sectors readily lend themselves to compliance with the STS eligibility criteria, given the nature of the underlying borrowers and loans. For example, collateral pools backing STS transactions cannot include exposures to borrowers who are credit-impaired or registered as having an adverse credit history.

Chart 2

STS Issuance Share, 2019 YTD (€ bil.)



STS--Simple, transparent, and standardized. YTD--Year to date, as of Oct. 31, 2019. Investor-placed issuance only. Excludes multi-domicile CLO and CMBS issuance.
Source: S&P Global Ratings.

More than one-third of total European securitization issuance to date this year has been from the collateralized loan obligation (CLO) and commercial mortgage-backed securities (CMBS) sectors, which generally look set to remain outside the STS definition. Scope for further growth in the STS issuance share will therefore depend on the relative strength of asset-backed securities (ABS) and RMBS volumes, but also the extent to which originators are willing to make the necessary changes--and accept the additional cost--of accommodating the STS criteria in these sectors. This could in turn depend on how positively investors respond to STS-labeled issuance.

STS Has Raised Issuance Costs But Also Investor Incentives

There is some evidence that the STS label has stimulated demand from bank investors in particular, as other European regulations now reference the label in a way that gives it economic weight. For some regulated investors--such as banks and insurers--exposures to securitizations with the STS label can attract lower regulatory capital charges than those without it. Similarly, from April 2020, only STS-labeled securitization exposures can count as high-quality liquid assets (HQLA) in banks' calculation of their liquidity coverage ratio (LCR)--another key regulatory test.

The numerous requirements for a term securitization to achieve STS status are set out in Articles 20 to 22 of the Securitisation Regulation (Regulation [EU] 2017/2402). Criteria regarding simplicity include stipulations on underwriting standards, homogeneity, and credit quality of the underlying collateral. Standardization requirements include early amortization triggers, performance trigger-based reversion to sequential paydown, and "appropriate" mitigation of interest rate and currency risks. Transparency requirements include provision of a liability cash flow model and at least five years' historical default and loss data for assets similar to the transaction's underlying collateral.

Banks' securitization exposures must meet additional requirements to benefit from lower regulatory capital charges or count as HQLA in the LCR test. For instance, under the EU Capital Requirements Regulation (CRR) for banks, preferential capital charges only apply to STS transactions if the underlying collateral pool satisfies additional criteria on granularity and credit quality. For RMBS, no underlying loan should have an indexed loan-to-value (LTV) ratio of more than 100%.

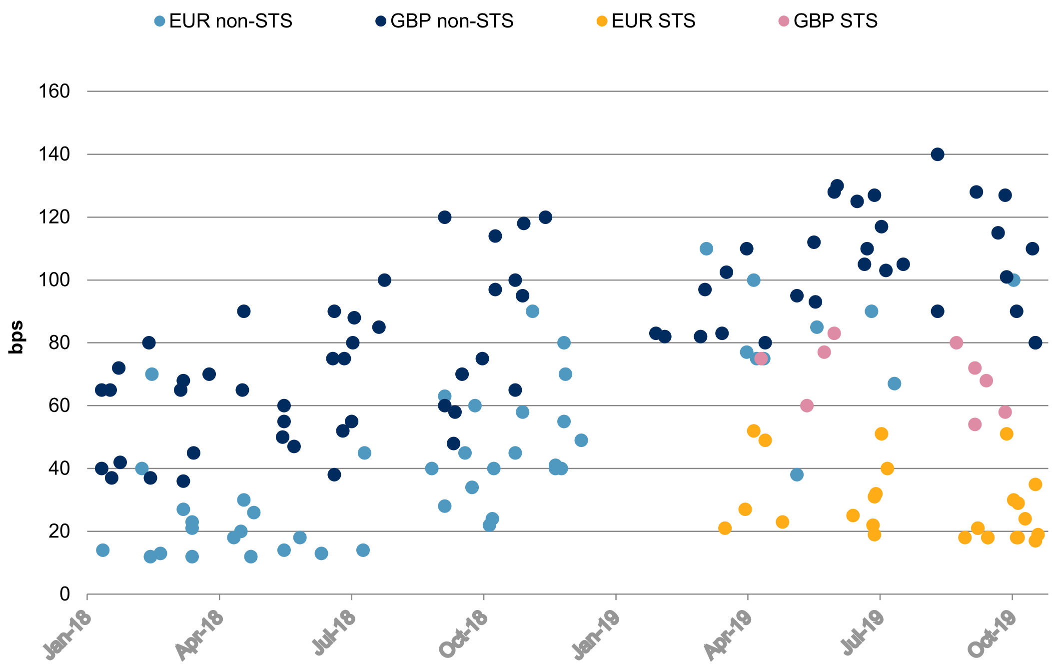
Originators that have embraced the STS label have likely had to revamp processes and incur additional costs to demonstrate compliance with all of the eligibility criteria. Most originators of STS transactions to date have employed a third-party verifier to provide an opinion on adherence to the criteria, helping to mitigate sanction risk under the new regime.

STS May Have Spurred Changes To Credit Profiles

The STS label was generally not conceived to comment on creditworthiness in the way that credit ratings do, for example. That said, some of the STS eligibility criteria--notably the exclusion of transactions backed by defaulted exposures or borrowers with adverse credit history--may mean that collateral pools of STS-compliant transactions are generally at the higher end of the credit quality spectrum. This is all the more likely when originators also seek to satisfy the additional requirements for beneficial treatment under the CRR.

Chart 3

New Issuance Discount Margins On 'AAA' Rated ABS And RMBS Tranches



Note: Investor-placed tranches only. Bps--Basis points. STS--Simple, transparent, and standardized. EUR--Denominated in euros. GBP--Denominated in British pound sterling. Source: S&P Global Ratings.

In terms of market pricing, newly issued tranches of STS transactions have generally been clustered at lower spread levels than those without the label (non-STS; see chart 3). However, these spread differentials are clearly not due to the introduction of the STS label per se. They simply reflect the fact that the STS criteria are more readily fulfilled in sectors that investors already considered to be lower-risk and more liquid. For example, 'AAA' rated U.K. prime RMBS tranches--which are now more likely to carry the STS label--have always priced tighter than 'AAA' rated U.K. nonconforming RMBS tranches, which generally have not had the label. We understand from market participants that there is not yet clear evidence of a pricing differential between tranches from STS transactions and tranches from transactions issued before 2019 that are otherwise similar, although this is hard to test.

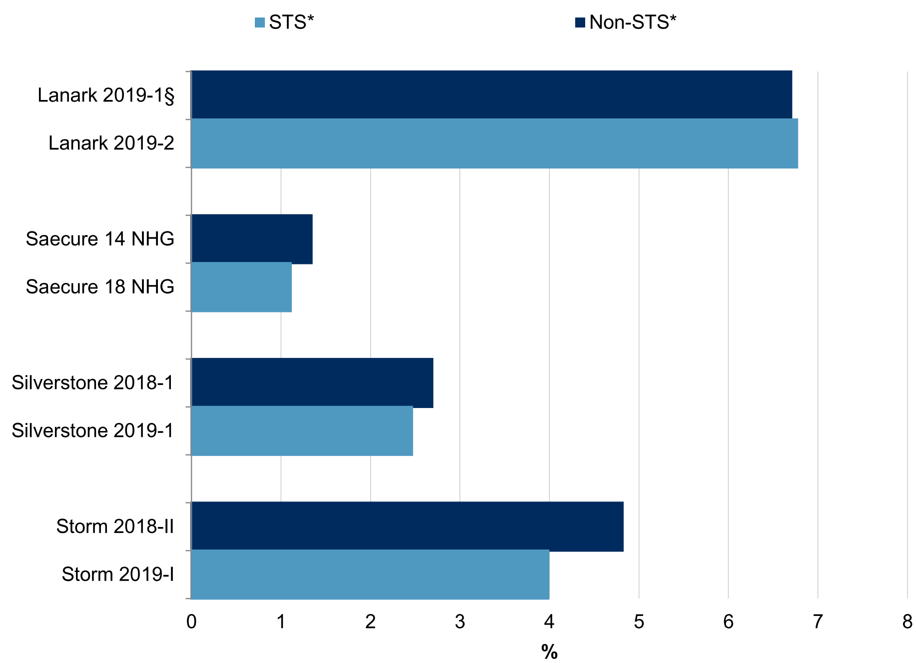
From a collateral credit quality perspective, it's also difficult to say whether recently issued STS transactions would have had different credit characteristics if they didn't have the label. We can, however, compare recent STS transactions with non-STS transactions issued before 2019 from the same issuance shelf.

The outputs of our credit analysis for RMBS transactions include the weighted-average foreclosure frequency (WAFF), weighted-average loss severity (WALS), and credit coverage (WAFF times WALS) that we would assume in a 'AAA' stress scenario. In general, the lower the WAFF, WALS, and credit coverage, the higher the collateral pool's credit quality. These measures of credit risk would therefore be higher for pools that include more borrowers that are credit-impaired or more loans with higher LTV ratios.

Based on a sample, the 'AAA' credit coverage at closing has often been lower for recent STS-compliant transactions than for non-STS transactions from the same shelf (see chart 4).

Chart 4

'AAA' Credit Coverage At Closing For Selected RMBS Transactions



*At time of issuance. §Lanark 2019-1 figures are re-calculated based on the current rating methodologies for residential loans in the U.K., "Assessing Pools Of Residential Loans," published on Jan. 25, 2019.
STS--Simple, transparent, and standardized. Source: S&P Global Ratings.

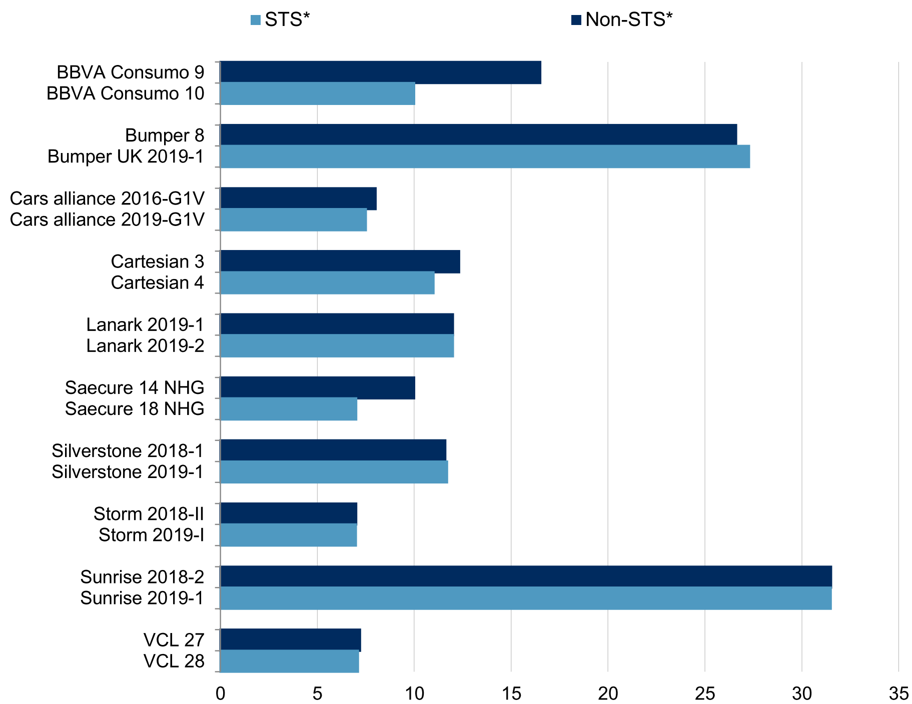
Other elements of the STS framework may be leading to certain risks being carved out of securitizations altogether. One of the STS eligibility requirements is that repayment of the holders of the securitization positions cannot "depend predominantly on the sale of the assets securing the underlying exposures." For some auto ABS transactions, this can be significant because investors may be exposed to residual value (RV) risk on the underlying vehicles. This may be the case when the transaction is backed by leases or, in the U.K. and Ireland, personal contract purchase (PCP) agreements.

However, if the underlying assets' values are guaranteed or fully mitigated by a repurchase obligation of the seller of the assets or another third party, then the "predominant dependence" clause doesn't apply. Some recent auto ABS transactions--such as STS-compliant Silver Arrow 10 or VCL 28, unlike the previous issues from the same shelf--include such buyback commitments, ensuring that the securitization investors do not bear the RV risk.

Overall, some of the transactions we sampled show collateral de-risking in their capital structures, which may have been spurred by application of the STS label. The attachment points, or levels of available credit enhancement, for senior tranches of recent STS transactions at closing have often been somewhat lower than for non-STS transactions issued previously from the same shelf (see chart 5).

Chart 5

Senior Note Attachment Point At Closing



*At time of issuance. STS--Simple, transparent, and standardized. Source: Bloomberg, S&P Global Ratings.

Ineligible Transactions Look Set To Coexist With STS Market

Despite causing some disruption to securitization issuance at the start of 2019, the new securitization regulations in Europe--and the STS label in particular--now appear to be gaining widespread acceptance and adoption. Although market participants may have borne costs in changing some of their processes, the upheaval may be justified by the potential for preferential regulatory treatment of STS exposures.

At the same time, the non-STS areas of the European securitization market do not appear to have been left behind, with no significant drop-off in the issuance of leveraged loan CLOs or nonconforming and buy-to-let U.K. RMBS, for example. This assuages the fears of some market participants before the STS label was introduced that it might lead to undue stigmatization of transactions and sectors that fall outside its scope.

While the market is, by definition, now bifurcated into STS and non-STS segments, these look set to coexist successfully, with STS exposures more likely to appeal to bank treasuries, while non-STS transactions may appeal to a wider group of investors. The issuance and investment process may have developed as a result of the Securitisation Regulation and the STS framework, but transaction characteristics have not seen wholesale changes or disruption.

Related Criteria

- Global Methodology And Assumptions: Assessing Pools Of Residential Loans, Jan. 25, 2019

Related Research

- Regulator Guidelines Pave The Way For STS Securitizations, July 30, 2018

This report does not constitute a rating action.